ACCA Certificate in Audit
(RQF Level 4)

FAU

Foundations in Audit

STUDY TEXT

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Chapter 1

AUDITING AND THE AUDIT PROFESSION

INTRODUCTION

This chapter provides an introduction to the role and function of auditing and considers the structure and regulation of the auditing profession.

This chapter covers syllabus areas A (1), A (5).

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LEARNING OUTCOMES

At the end of this chapter, you should be able to:

- explain the nature, purpose and structure of an audit
- appreciate the main mechanisms which currently regulate the auditing profession
- explain the role of both auditing and accounting standards.

1 THE NATURE OF ACCOUNTING RECORDS AND AUDIT

1.1 THE NATURE OF ACCOUNTING RECORDS

Businesses, both sole traders and incorporated companies, need to satisfy the informational needs of a wide range of stakeholders. Examples of typical stakeholders and their informational requirements include:

- Shareholders – they need information about company performance to aid investment decisions
- Lenders/financial institutions – they need information about the liquidity of a business to make lending decisions
- Government institutions – they need information to support the calculation and payment of relevant corporation and income taxes
- Management – they need information to support operational decisions and business strategy
- Employees – they need information relating to the liquidity and performance of a business to assess job security and remuneration potential
- Customers/suppliers – need information about the liquidity of a business to decide whether to commit to long term trading partnerships
- The public – they require a wide range of data, environmental and corporate social responsibility information is currently popular.

Each stakeholder requires good quality information to assist their decisions, all of which are significant to the stakeholder in question. If the information they use is of poor quality then they are likely to make poor quality decisions. Therefore providing them with the correct quality of information is a significant undertaking.

In order to meet these requirements, company directors/management prepare a number of reports for use by the stakeholders identified above. They are too numerous to prepare a comprehensive list so a summary of some of the key documents is included below:

- Management accounts – these are typically used internally by management and employees for internal, operational and financial decisions. They include budgets/targets, performance to date and management commentaries. These are occasionally provided to lenders, at the discretion of management, to support loan/finance applications.
- Taxation computations and returns – these include summaries of sales and purchases to support sales tax and corporate tax payments and payroll reconciliations to support the payment of income taxes and social security payments.
- Financial statements – these incorporate summaries of historical financial performance (statements of comprehensive income and cash flows) and summaries of year-end assets and liabilities (statement of financial position). These are usually required by law for most companies and are used primarily by shareholders, although they are available to the public.

Whilst there are different requirements for each piece of information produced there are two specific requirements of information reported in the financial statements that are significant, in accordance with the IFRS Conceptual Framework for Financial Reporting (Conceptual Framework), information presented in the financial statements must:

- be relevant, meaning that the information must be capable of influencing the users' decisions, and
- faithfully represent the transactions and balances it is reporting, meaning it must be complete, neutral and free from error.

Financial information must also be understandable, produced on a timely basis, be comparable and be verifiable.

It is vital that management has systems in place that support the preparation of this information. Management must ensure that appropriate systems are established, including financial accounting systems, and that appropriate controls are designed to reduce the risk of fraud and error and to detect such problems if they do occur. Management must also establish systems sufficient to keep such records as long as they are required by stakeholders. For example, in the UK business records must be kept for a minimum of six years to satisfy tax regulations.

See Chapter 16, section 1.4 for more on what constitutes 'proper accounting records'.

1.2 WHAT IS AN AUDIT?

Whilst it is, of course, important to have a sound grasp of the meaning of the subject which you are studying you are not likely to be assessed directly on the definition of the word 'audit.' It is therefore more important to grasp an appreciation of the ideas involved in the audit concept than to attempt to learn a definition word for word.

One possible definition of an audit is:

"The independent examination of evidence from which the financial statements of an entity are derived in order to give the reader of those statements confidence as to the 'truth and fairness' of the state of affairs which they disclose."

An alternative view is presented by ISA 200 *Overall Objective of the Independent Auditor and the Conduct of an Audit in Accordance with ISAs,* : the objective of an audit is 'to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework'.

What can we see as the essential features of an audit from a combination of these definitions and explanation?

- An audit involves an examination of financial statements – the auditor is not responsible for the preparation of financial statements. In the case of a limited company, it is the responsibility of the directors to prepare the financial statements – the auditor then examines the financial statements and reports an opinion on the 'truth and fairness' of the state of affairs disclosed.
- The end result of an audit is an opinion to assist the user of the financial statements – auditing therefore relies heavily on professional judgement, not merely facts.

- The auditor's opinion makes reference to a true and fair view (being presented fairly in all material respects) – but true and fair is again a matter of judgement – it is not precisely defined for the auditor.

In order for the user of the information to feel confident in relying on the auditor's report, the auditor should be independent of the entity subject to audit – independent essentially means that the auditor has no significant personal interest in the entity. This allows an objective, professional view to be taken.

You will note that this is a wide concept of an audit which can be applied to any entity, not just to limited companies. However we are concerned here primarily with the annual audits of the financial statements of limited companies (often known as statutory or external audits). Any other audit applications will be clearly indicated for you in the text.

1.3 EXAMPLE OF AN INDEPENDENT AUDITOR'S REPORT

It is appropriate to consider in brief the format and content of an independent auditor's report. This will be considered in more detail in subsequent chapters of this publication.

You should note the following details within the specimen report as follows:

(a) a title identifying the person(s) to whom the report is addressed

(b) the auditor's opinion on the financial statements

(c) the basis of the auditor's opinion

(d) responsibilities of management

(e) responsibilities of the auditor

(f) the auditor's signature and address

(g) the date of the auditor's report.